

HORIZON HEALTHCARE SERVICES, INC.

NAIC NUMBER 55069

NAIC GROUP NUMBER 1202

LIMITED SCOPE EXAMINATION

MARCH 29, 2008

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March 25, 2009

Honorable Steven M. Goldman
Commissioner of Banking and Insurance
Department of Banking and Insurance
State of New Jersey
20 West State Street
Trenton, New Jersey 08625-0325

Dear Sir:

In compliance with your instructions and in accordance with Section N.J.S.A. 17:23-22 3(a), a limited scope examination has been performed, of certain activities of:

HORIZON HEALTHCARE SERVICES, INC.

NAIC GROUP CODE 1202

NAIC COMPANY CODE 55069

A Health Service Corporation (HSC) authorized to transact business in the State of New Jersey (hereinafter “the Company” or “Horizon”), at its headquarters, located at Three Penn Plaza. E Ste PP-15D Newark, New Jersey 07105 -2248, and other locations as appropriate, and the following Report on Examination is submitted.

National Headquarters

Horizon HealthCare Services, Inc.
Three Penn Plz. E Ste PP-15D
Newark, New Jersey 07105 -2248

Statutory Home Office

Horizon HealthCare Services, Inc.
Three Penn Plz. E Ste PP-15D
Newark, New Jersey 07105 -2248

EXECUTIVE SUMMARY

This limited scope examination of Horizon’s compensation program focused on five major components: Board Governance, Job Complexity, Company Complexity, Competitive Compensation Market and Company Performance Measures. Objectives of the examination included assessing the

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1. Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Executive Compensation Committee, *Published by the National Association of Corporate Directors*, 2002.
2. Commission on Public Trust and Private Enterprise, Executive Summary: Findings and Recommendations, **The Conference Board**, Special Report 4, 2003, pp 6-7.

adequacy and appropriateness of the Board and Compensation Committee's overall review process, assessing the adequacy of the methodologies employed, assessing the comparability of competitive market data to the Company's executive employment market, determining the appropriateness of the Board and Compensation Committee's conclusions regarding the fairness and reasonableness of the its executive compensation program and determining whether key personnel, including the Compensation Committee, are free of conflicts.

To achieve these objectives we reviewed the governance structure and process pertinent to executive compensation, the program design and the program administration. The key executives whose compensation plans were considered during this review are:

- President and Chief Executive Officer (William J. Marino)
- Senior Vice President – Health Care Management (Christy W. Bell)
- Senior Vice President – Service (Patrick J. Geraghty)
- Senior Vice President – Marketing Business Units (Robert A. Marino)
- Senior Vice President – Chief Financial Officer (Robert J. Pures)
- Senior Vice President – Chief Information Officer (Mark Barnard)
- Senior Vice President – General Counsel and Secretary (John W. Campbell)

Based on the procedures performed, we have the following observations:

1. The Company is not a publicly traded company on the NYSE or NASDAQ. However, it has chosen to adopt and follow the governance standards set forth by these exchanges. This voluntary decision to apply the exchange standards is an indication of a strong corporate governance environment.
2. The Company's overall positioning of executive compensation is below market target levels in comparison to its peer group. Horizon's current total direct compensation (combination of base salary, annual and long-term incentives) is delivered at approximately eighty-one percent (81%) of, or nineteen percent (19%) below, it's identified competitive market level.
3. The Company's peer group consists of ten (10) companies within its competitive market, most of which have compensation plans which are somewhat unique and generally not similar to that of the Company. In addition, the financial size of the peer group entities cover a significantly diverse range, with the Company falling near the median of the companies making up the peer group in terms of revenues. The Company also performs better than its comparator group on operational measures such as net income and enrollment. These factors make it difficult for Horizon to assess the comparability of its compensation plans to those of the peer group (lack of multiple companies with similar practices). The size and composition of the peer group reflects the input of the Company's and the Personnel and Compensation Committee's independent compensation consultants.
4. Company executives state that Horizon competes against for-profit organizations, despite being a not-for-profit entity. Its service offerings are comparable to those offered by for-profit

organizations in the same industry such as Aetna, CIGNA Corporation and United Healthcare. Horizon does not face the same SEC, NYSE or NASDAQ regulatory and compliance standards that for-profit or public companies are subject to (e.g., proxy report filings). The Company did not establish a not-for-profit peer group even though Horizon is currently classified as not-for-profit.

5. Significant overlap exists between the measures that drive the Annual Incentive (Short Term) and Long-Term Incentive programs. The overall weighting for both the short-term and long-term plans measure the same performance for two measures, enrollment (50%) and customer and physician satisfaction (25%). While five (5) of the Company's ten (10) peer companies have membership goals as one of their short-term incentive performances measures, the weightings assigned to enrollment were substantially lower than the 50% weighting currently used by Horizon. None of the Company's long-term incentive performance measures were similar to those found in that of its peer companies.

BACKGROUND

Horizon is the leading health insurance provider in New Jersey. The Company has annual revenues of approximately \$7 billion. With over 3.5 million members enrolled in its plans, Horizon's market share of New Jersey is approximately 42%. The Company offers managed care, Medicare, Medicaid and traditional indemnity health plans for individuals, families, and groups, and has the exclusive right to market their products and services using the Blue Cross Blue Shield names and marks in New Jersey under license agreements with the Blue Cross and Blue Shield Association. The Company also offers several other products including pharmacy and dental benefits

The New Jersey Department of Banking and Insurance ("NJDOBI") authorized a limited scope examination of Horizon Healthcare Services, Inc. and its affiliates ("Horizon"), to review and assess the corporate governance and controls related to executive compensation arrangements between the Company and its executive management team.

As part of the examination of historical and prospective risk associated with executive compensation, the NJDOBI retained an executive compensation expert from RSM McGladrey, Inc. to conduct a review of Horizon's governance structure, process, and competitive market intelligence utilized in establishing and administering executive compensation. The expert assessed the appropriateness and reasonableness of the governance process. The expert also provided the NJDOBI with workpapers that included a discussion and analysis of the assessments reached regarding the adequacy and appropriateness of the Company's governance structure, Board involvement pertinent to executive compensation, and adequacy of the methodologies employed in managing this program.

SCOPE OF EXAMINATION

The scope of the review included assessing the adequacy of Horizon's corporate governance structure and process pertinent to its executive compensation, compensation program design and administration. We followed the concepts for risk identification and residual risk assessment embedded in the NAIC Financial Condition Examiners Handbook (Risk-focused Handbook). The scope of this project did not include conducting a complete compensation study. The findings and assessments were based on documentation and information provided by Horizon. Specifically, our review of Horizon's compensation program incorporated the following procedures:

- A thorough review of the Company's business planning documents relating to the management and administration of the executive compensation program
- Detailed interviews with key members of the Company's management team and board of directors
- Additional research regarding executive compensation standards and best practices
- Reviewing various components of the compensation program and assessing its impact on the establishment of compensation strategy and the resulting pay levels to the seven key executives covered in this study
- Documentation of observations, findings and recommendations

Specifically, we considered the following areas during our review:

Board Governance

- Reviewing policies, practices, and governance guidelines related to the approval of the compensation program to ensure that the appropriate oversight is in place at Horizon

Job Complexity

- Reviewing the roles of each key executive to determine if compensation levels take into consideration any unique responsibilities

Company Complexity

- Reviewing the organizational uniqueness of Horizon to determine if external comparisons and benchmarks are accurate

Competitive Compensation Market

- Reviewing Horizon's external compensation benchmarks to determine their appropriateness for setting target pay level
- Assessing whether Horizon's actual pay levels are in line with their compensation strategy and philosophy

Company Performance Measures

- Reviewing performance measures for the annual and long-term incentive plans to assess if measures and weightings are consistent with business objectives

- Reviewing historical goal achievement to determine if target performance levels are set appropriately

In performing our procedures, we reviewed an extensive range of Company documentation, policies, and guidelines to assess the degree to which Horizon's compensation program is in line with the Company's stated compensation philosophy and strategy. Documentation reviewed included, but was not limited to the following:

- Documented executive compensation strategy
- Strategic business plan
- Governance guidelines
- Most recent financial statements
- Compensation Committee charter and by-laws
- Compensation Committee resumes
- Organization charts
- List of major competitors
- Job descriptions for positions covered in the audit
- Relevant communications between the Company, the Board, and the Compensation Committee
- Third-party competitive market analysis and benchmarking of executive positions
- Third-party recommendations for market positioning, plan design, performance metrics, award calculations
- Salary administration program policies and procedures
- Current salary grades and ranges
- Short- and long-term incentive plan documents
- Executive perquisite programs

COMPANY COMPENSATION AND PHILOSOPHY STRATEGY

According to documentation provided, the Company's stated compensation philosophy and strategy:

- Horizon will structure and administer its executive compensation program so as to deliver total pay that is competitive in aggregate by grade relative to the markets in which Horizon competes for talent and consistent with its stated mission and relative performance
- Management and the Board will exercise judgment in their periodic reviews to

- Promote variation by individual based on performance, function, and responsibilities. Incentive compensation will foster performance (measured at company, business unit, and individual level) which reflects Horizon's mission on an annual and longer-term basis

Our review noted that Horizon's compensation strategy does not document the following key points:

- Frequency with which market compensation targets should be identified
- Frequency with which a market compensation analysis is conducted.
- Its competitive compensation marketplace (e.g. peers, scope, size, industry focus)
- The role of individual executive performance in determining compensation competitiveness
- Desired mix of base salary, annual incentives and long-term incentives
- Determinants of market compensation competitiveness (performance metrics)
- Stated relationships between organizational performance standards and market positioning (e.g., performance at target levels should deliver compensation equivalent to the market competitive rate)
- Instances in which management and the Board can exercise judgment in their periodic review of the program

BOARD GOVERNANCE

Company Boards of Directors in concert with their Compensation Committees should maintain executive pay packages that are fair and reasonable, both internally and externally. Internal fairness means that the executive team shares in the success when the organization performs well. External fairness is based on performance relative to an absolute standard and/or performance as measured against peer companies endorsed or selected by the Compensation Committee.¹ The governance orientation of the company may directly impact the reasonableness and fairness of the compensation and compensation opportunities. Specific standards for the governance process including the conduct of the Compensation Committee have been defined in the requirements for companies listed on the NYSE and the NASDAQ. Many of these generally accepted standards were used as a basis for this review. In addition, standards set forth by the Commission on Public Trust's Key Recommendations on Executive Compensation were also utilized to determine if the governance orientation of Horizon supported the development of a fair and appropriate executive compensation framework.²

Governance Posture

Even though Horizon is not a publicly traded company on the NYSE or NASDAQ, the company has chosen to follow the governance standards set forth by these exchanges. Given that these organizations establish clear guidelines for effective governance, adherence to these standards should result in an appropriate governance posture.

References

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1. Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Executive Compensation Committee, *Published by the National Association of Corporate Directors*, 2002.
2. Commission on Public Trust and Private Enterprise, Executive Summary: Findings and Recommendations, **The Conference Board**, Special Report 4, 2003, pp 6-7.

Governance Guidelines

The development of comprehensive governance principles are essential for the Board to carry out its oversight roles. Horizon maintains corporate governance guidelines which define the general conduct and affairs of the board. The guidelines describe policies and processes the Board has adopted which are consistent with effective oversight. These include: Board composition and Board size, Director qualifications, Director responsibilities, Board agenda and lead director, Board committees, member access to management, Director education and evaluation of Director performance.

Specific governance principles relative to effective oversight of the executive compensation program should be adopted by the Board. These include the following principles which serve as criteria to assess the governance process relative to the fairness and reasonableness of executive pay: Director Independence, utilization of a committee focused on executive compensation, assignment of Directors to the Committee, defining Director Responsibilities, Director evaluation and Director development.

Director Independence

Independent Directors present the opportunity to provide advice and guidance without potential conflicts of interest. The Company uses the NYSE definition of Director independence. 80% of the Board members are independent Directors. All Personnel and Compensation Committee members are independent.

Compensation Committee

A separate committee of the board dedicated to compensation and benefit programs is needed to exercise informed judgment relative to complex compensation issues. Horizon maintains a Personnel and Compensation Committee with a specific charter which outlines accountabilities for reviewing and establishing executive pay levels.

Director Assignment to the Personnel and Compensation Committee

Directors on the Compensation Committee should be assigned to the committee by the Board based on their skills and independence. The Governance Committee of the Board for Horizon recommends assignment to this committee based, in part, on Director qualifications.

Director Responsibilities and Director Evaluation

The role of Directors should be defined and used, in part, as a baseline to assess Director contribution and performance. The Director responsibilities are defined in Horizon's governance guidelines and a process is recommended for individual Director evaluation. All Directors participate in an Orientation program and receive materials on the roles and responsibilities of Directors and background on the business and operations of the Company at the time of their election or appointment to the Board.

Director Development

The role of Director requires ongoing training and development to remain current with critical issues. This is especially important for Directors who serve on specialized committees (e.g., Audit or Compensation). The Horizon Guidelines encourage Directors to take advantage of developmental

opportunities. Available documentation does not indicate the level and type of education engaged in over the past year.

Personnel & Compensation Committee

The Personnel and Compensation Committee (the Committee) consists of Aristides W. Georgantas (Chair), Barbara Bell Coleman, Emmanuel A. Kampouris, Leo J. Rogers, Jr., William J. Marino (Ex Officio Attendee) and Vincent J. Giblin (Ex Officio Attendee). The policies, procedures, and general conduct of the Committee were reviewed to ensure that the foundation for informed, objective, and independent decisions were made relative to the pay program. The following are specific standards which were reviewed relative to the Committee.

Committee Charter

The Board maintains a well documented compensation committee charter which defines the duties, membership, authority, responsibilities, and procedures specific to the committee. The Committee charter presents a governance structure which, if adhered to, provides the foundation for effective oversight of the executive compensation program.

Appropriate Scope of the Executive Compensation Review

The Committee Charter defines the specific oversight responsibilities for recommendations pertaining to base salaries, annual incentive compensation, long-term incentive compensation, and any other compensation.

Committee Member Independence

The charter of the Committee indicates only independent Directors will serve on the Committee. Based on input from management and a review of the biographies of current committee members, all committee members qualify as independent based on the independence requirements set forth by the New York Stock Exchange.

Reporting to the Board and Board Authority

The recommendations developed by the Committee should be reviewed and adopted by the full board. This establishes an appropriate check and balance system and assists the Board in aligning pay with the stated compensation philosophy. The charter of the Committee requires that it will report all recommendations with respect to executive compensation to the Board for action.

Committee Evaluation

The Committee charter requires a self-evaluation every year. The results of this evaluation were not reviewed but management reported that the results indicated that the Committee was functioning well.

Committee Process

Interviews with management who support the Board, interviews with Directors, a review of Committee meeting notes, and a review of the charter all provide insight relative to the Committee process. Criteria established to ensure the process informed all Committee members and addressed the

right issues include: format and tone of Committee deliberations, selection and use of external advisors, agenda management, executive sessions, Committee member capabilities, and compensation strategy.

Format and Tone of Committee Deliberations

The Committee minutes indicated the Directors conducted a systematic review of the compensation program. Topics reviewed include base salaries, annual incentive measures and performance targets, and long-term measures and targets.

Executive Sessions

Executive sessions without management are critical to promote an informed and unbiased dialogue relative to executive pay issues. The Committee utilized executive sessions without the presence of management to conduct deliberations about pay levels.

Selection and Use of External Advisors

The increasing complexity of building and maintaining executive compensation programs requires significant expertise in this content area. The Committee has a history of utilizing experienced compensation consultants who have not worked with management to provide advice on technical and compensation design issues. The Committee also has its own independent compensation consultants and counsel.

Committee Member Capabilities

The current Committee members have corporate experience with organizations which are as complex and market driven as Horizon. In addition, the members have significant governance experience and have addressed executive compensation issues in a number of organizations at the Board level as well as in the role of executive at the corporate level.

Agenda Management

In order to provide an open forum for discussion of relevant issues, it is important for members of the Committee to have access to the agenda. The topics reviewed and the decisions made at committee meetings are documented. Committee members are free to provide input to the Committee chairman on agenda items.

Compensation Strategy

The current documented compensation strategy is rather limited relative to addressing all of the key executive compensation-related issues and program components. The executive compensation strategies articulated by larger public companies within the Compensation Committee reports of their public filings typically outline the position taken by the Board on various compensation-related topics and pertinent to each component of the pay program (e.g., contribution of annual incentive to total pay). These disclosures should provide a solid foundation for all committee decisions pertaining to pay. Horizon's Committee may wish to consider developing a broader overview of the executive compensation philosophy (see Towers Perrin document for Horizon's response).

JOB COMPLEXITY

Horizon does not have a Chief Operating Officer position. Members of the management team comprise an operating committee that collectively fulfills the role of the COO. Competitive compensation for the following individuals is benchmarked in part to COO data in published surveys, along with other data pertinent to their primary jobs:

Christy Bell	Senior Vice President - Health Care Management (data excluded in 2007)
Patrick Geraghty	Senior Vice President - Service
Robert Marino	Senior Vice President - Marketing Business Units

Horizon's benchmarking of roles appropriately takes into account the scope of unique duties that apply to its executives.

COMPANY COMPLEXITY

Company executives state that the Horizon competes against for-profit organizations, despite being a not-for-profit entity. The Company offers a full suite of health plan products, as well as several specialty products and service subsidiaries, which are comparable to service offerings offered by for-profit organizations in the same industry such as Aetna, CIGNA Corporation and United Healthcare. Horizon, operating as a not-for-profit company, does not face the same SEC and NYSE regulatory and compliance standards that for-profit or public companies are subject to (e.g., proxy report filings).

After reviewing the mix of business and service offerings at Horizon, there are no major additional lines of business that indicate Horizon is more complex than their competitors. Consequently, we find that no premiums to compensation levels based on company complexity are necessary.

COMPETITIVE COMPENSATION MARKET

Horizon engages Towers Perrin to provide executive compensation advisory services. All observations, findings and recommendations that follow identifying Horizon actually refer to the collective efforts of both Horizon and Towers Perrin unless otherwise noted. All compensation matters are also reviewed with the Personnel and Compensation Committee's independent compensation consultants.

Horizon views its competitive market as health insurance providers of relevant size without consideration of the profit status of the entities. It utilizes two sources of external market data to identify competitive market practices such as pay levels and pay delivery mechanisms which are the financial statements (proxies) of its selected peer group as well as primary and secondary published compensation surveys. A 50:50 blend of peer group and published survey data is utilized for setting base salary and total cash compensation levels. A 50:50 blend of peer group data and a proprietary

Towers Perrin trend line of life and health insurance companies is utilized for setting for long-term incentives

Horizon's selected peer group consists of the following ten publicly-traded companies within the Health Insurance/Managed Care industry:

<u>Peer Company</u>	<u>2006 Revenues</u>
1. Aetna	\$ 25.1 billion
2. Humana	\$ 21.4 billion
3. CIGNA	\$ 16.5 billion
4. Health Net	\$ 12.9 billion
5. Assurant	\$ 8.1 billion
6. Coventry Health	\$ 7.7 billion
7. WellCare	\$ 3.8 billion
8. AMERIGROUP	\$ 2.8 billion
9. Centene	\$ 2.3 billion
10. Molina Healthcare Inc	\$ 2.0 billion

Horizon's peer group is very diverse in terms of financial size and scope. Only two companies in the peer group (Assurant and Coventry Health) have 2006 revenues comparable to Horizon's revenues. The largest company in the peer group is more than three times larger of Horizon, and the smallest company is less than a third the size of Horizon. The largest company is more than ten times the size of the smallest in the group.

The peer groups developed by financial analysts in industry reports (currently used by Horizon to develop its peer group) appear to be based more on industry niche than financial size or scope. The peer group's limited sample size within the competitive market (10 companies) combined with its diversity in financial size and scope make it difficult for Horizon to assess the comparability of its compensation plans to those of the peer group (lack of multiple companies with similar practices). Most of the peer companies' compensation plans are somewhat unique, with the smaller companies having less specific performance metrics defined for executive compensation.

Horizon's total revenues for 2006 and 2007 totaled \$6.9B and \$7.4B, respectively. The Company has projected 2008 revenues totaling \$8.1 billion. The median revenue of its peer group is \$7.9 billion, based on 2006 revenues as indicated above.

Horizon did not establish a non-profit peer group even though Horizon is currently classified as tax-exempt. The peer group portion of Horizon's "targeted market levels" therefore is not balanced between for-profit and non-profit, while a substantial effort is made to establish this balance for the

published compensation survey portion including weighted factors of 50% for-profit public companies, 25% for-profit public and private companies and 25% non-profit companies. The heavier weighting of the “for-profit” organizations in the peer group yields market data points influenced by organizations tending to have “lead-the-market” compensation philosophies.

Horizon’s competitive market position is defined as a sum of the total cash compensation and long-term incentive targets to derive total direct compensation. The 50th percentile of the combined peer group and published survey data (the “combined data”) is utilized for base salary and total cash compensation, while the 60th percentile of the combined data is utilized for total direct compensation. The Compensation Committee approved a reduction of the target total direct compensation from the 75th to 60th percentile during 2001. Horizon’s current overall positioning of executive compensation below market target levels is supported by the disparity between prevailing for-profit and non-profit compensation philosophies. Horizon’s actual aggregate executive compensation market positioning for the seven executive positions reviewed include the following targets below the combined data discussed above:

Base salary	- 10%
Total cash compensation	- 16%
Total direct compensation	- 19%

COMPANY PERFORMANCE MEASURES

Horizon has adopted a pay-for-performance philosophy in which individual performance (and total direct compensation position-to-market) drives base salary increases. Aggregated performance is measured against various corporate and business unit goals which drive annual incentive and long-term incentive awards (see Towers Perrin document for Horizon’s response).

Total direct compensation is derived based upon the following component weighting schemes (aggregated across Horizon’s seven executive positions):

Total direct compensation

- 28% fixed versus 72% variable (percent of total direct compensation)
- 31% variable short-term versus 69% variable long-term (percent of all variable compensation)

As a percent of base salary

- 79% for annual incentives
- 179% for long-term incentives

Horizon’s total direct compensation component weighting schemes are adjusted based upon individual positions’ ability to impact business results. For example, less-leveraged models (more emphasis on fixed compensation) are used for General Counsel and the Chief Information Officer.

Individual base salary adjustments, as well as the annual adjustment to targeted total cash and total direct compensation levels are determined by a combination of individual annual performance rating (ratings of “3” or better in a five-point scale) and individual total direct compensation versus the targeted market (e.g. 60th percentile).

Annual Incentive Plan

The stated purpose of the Annual Incentive Plan at Horizon is to ensure that employees are provided total cash compensation that is competitive in the marketplace. The plan is designed to reinforce business strategies and recognize contributions by encouraging individual and corporate accountability. Each participant is assigned a target award calculated as a percentage of base salary. The plan provides an incentive for achieving goals established on an annual performance period basis. Performance measures are approved by the Board of Directors prior to the beginning of the performance period, and each measure is assigned a weighting. Minimum (threshold), target, and maximum (optimum) performance levels for each measure are defined, and threshold and optimum levels of performance earn incentives of 50% and 150% of target levels respectively. Performance between threshold and target, and between target and optimum will earn rewards pro-rated on a straight line basis. A comparison of the Annual and Long-Term Incentive plan metrics is presented below.

Long-Term Incentive Plan

The stated purpose of the Long-term Incentive Plan at Horizon is to focus the attention of selected officers on the long term goals of the company and to provide rewards over time for the accomplishment of these goals. The target award of a Horizon officer is determined by the Board of Directors. The plan is designed with overlapping three-year performance periods and three-year payout periods, with no more than three measures set for each performance period. If there is more than one measure, each measure is assigned a relative weighting. Minimum (threshold), target, and maximum (optimum) performance levels for each measure are defined, and as with the Annual Incentive Plan, performance between threshold and optimum will earn pro-rated rewards between 50% and 150% of target. Upon completion of each performance period, individual awards are calculated, with one-third of each award being paid out upfront, one-third paid out at the beginning of the second year of the payout period, and the remaining third being paid out at the beginning of the third year. Accumulated interest is paid on each deferred portion of the Long-Term Incentive Plan. A comparison of the Annual and Long-Term Incentive plan metrics and weighting is presented below.

	Annual Incentive Plan	Long-Term Incentive Plan
Enrollment	50.0%	50.0%
Member Satisfaction	12.5%	12.5%

Physician Satisfaction	12.5%	12.5%
Underwriting Income	25.0%	-
Clinical Quality	-	25.0%

Significant overlap exists between the measures that drive the Annual and Long-Term Incentive programs; seventy percent (75%) of overall weighting is attributable to enrollment and the customer experience. Therefore under the Company's plan the degree of achievement of goals on the annual incentive plan generally determine the degree of achievement of goals on the long-term incentive plan. This causes redundancy in value of the two programs as both short-term and long-term plans measure the same performance. This may cause executives to focus exclusively on one component of organizational strategy (e.g. enrollment) at the expense of other long-term objectives.

Horizon's short-term incentive plan has paid out between target and optimum levels sixty-four percent (64%) of the time over the past fourteen (14) years. Horizon's long-term incentive plan has paid out between target and optimum levels ninety-two percent (92%) of the time over the past twelve (12) performance cycles.

Horizon has benchmarked the Enrollment and Underwriting Income performance to its competitive market. The competitive market is defined as other BCBS Member Plans and Publicly-Traded Companies. An eight-year compounded annual growth rate is used to compare annual performance to the competitive market. Horizon asked Towers Perrin to assess the distribution of incentive payouts for public companies, financial services companies, as well as general industry companies. Towers Perrin was only able to report on annual incentive payouts as data for long-term incentive payouts was not available. The following table summarizes the percentage of companies that make annual incentive payouts between target and optimum award levels, in comparison to Horizon.

	General Industry	Public Companies	Financial Services	Horizon
All organizations	54%	64%	65%	64%
Weak performing companies	--	25%	54%	64%
Strong performing companies	--	77%	68%	64%

The frequency of Horizon's short-term incentive payouts between target and optimum (64%) is comparable to companies that are performing strongly. While Towers Perrin did not identify comparable data for long-term incentive payout frequency, the frequency of Horizon's long-term payouts between target and optimum (92%) seems high relative to commonly-accepted usage of "threshold/target/maximum" performance ranges, where there is typically a strong central tendency.

Horizon is performing better than comparable public companies and other Blue Cross Blue Shield plans based on a compounded annual growth rate analysis of underwriting income and enrollment. However, when assessing year-over-year absolute growth for both underwriting income and enrollment, Horizon's growth has fluctuated significantly. The rate of year-over-year enrollment growth from 2002 to 2005 slowed each year, before a 6% increase in growth from 2005 to 2006. The rate of year-over-year net income growth fluctuated between 50% and 1% growth from 2002 to 2005, with net income decreasing 16% from 2005 to 2006. These changes were the result of strategic business decisions made by management and the Board at that time.

Horizon's 2006 performance on "Growth in Total Controllable Member Enrollment" was over "optimum" or "maximum". Horizon has set its 2007 "Member Enrollment" target below 2006 actual performance and its 2008 "Member Enrollment" target below 2007 projected performance.

Only five out of Horizon's ten peer companies have enrollment (membership) goals as one of their short-term incentive performance measures, with weightings assigned to enrollment of between 10% and 15%. This is substantially lower than the 50% weighting currently used by Horizon.

All ten companies in Horizon's selected peer group have some financial measure (e.g., income or revenue) as one of their short-term incentive performance measures, with weightings assigned to financial measures of between 55% and 80%. This is substantially higher than the 25% weighting currently used by Horizon. The disparities between metrics used in the short term incentive plans of its peer group, in comparison to its own incentive plans, supports our recommendation of creation of a not-for profit peer group.

None of Horizon's long-term incentive performance measures were similar to those found in peer companies

SUMMARY OF COMMENTS AND RECOMMENDATIONS

(See Towers Perrin document for Horizon's response)

Company Compensation and Philosophy Strategy

It is recommended that Horizon consider revising its compensation philosophy statement to articulate a broader strategy with which the Board can use to govern the executive compensation program. The following common points should be considered:

- Frequency with which market compensation targets should be identified
- Frequency with which a market compensation analysis is conducted.
- Its competitive compensation marketplace (e.g. peers, scope, size, industry focus)
- The role of individual executive performance in determining compensation competitiveness
- Desired mix of base salary, annual incentives and long-term incentives
- Determinants of market compensation competitiveness (performance metrics)

- Stated relationships between organizational performance standards and market positioning (e.g., performance at target levels should deliver compensation equivalent to the market competitive rate)
- Instances in which management and the Board can exercise judgment in their periodic review of the program

Competitive Compensation Market

It is recommended that Horizon consider increasing the number of companies in its proxy peer group based upon currently suggested standards: William M. Mercer suggests using 10 to 15 companies while the Hay Group recommends using 10 to 20 companies. Calculating percentile rank scores (e.g. 50th and 60th percentiles) from a larger sample yields results that are more reliable (replicable over multiple measures) and are usually more representative of the sample. Horizon should review its peer companies' respective peer groups as a starting point to identify candidate companies.

In addition to increasing the number of peer companies, it is recommended that the Company replace the largest and smallest companies in its peer group with organizations more similar in size to Horizon (e.g. \$6 billion to 8 billion). It may also need to add companies with a slightly different industry focus to achieve a more comparable group based upon size and scope. Extreme differences in organizational size and financial scope often impacts executive compensation practices more than industry focus. See **Appendix A** for a list of public companies which could be utilized as a starting point.

It is recommended that Horizon consider expanding its peer group to include non-profit organizations. A non-profit sample would, at the very least, provide an anchor point for interpreting the broader market data and a starting point for the competitive positioning of executive compensation. In addition, inclusion of non-profit peer organizations would increase the relevance of Horizon's overall market assessment in the event of an IRS audit. The executive compensation levels officers within non-profit organizations are reported to the IRS via Form 990 tax disclosures, which are comparable to the proxy statements of public companies for the purposes of identifying competitive levels of total cash compensation. The visibility of this data is going to increase dramatically in 2008; new IRS Form 990 guidelines have just been released pertinent to executive compensation, mandating a more detailed disclosure of a broader group of executives and each component of total compensation (base salary, annual incentives, others). See **Appendix B** for a sample of potential Non-profit Companies that could be considered.

Company Performance

It is recommended that Horizon considers further differentiation between their short- and long-term performance measures. Short-term incentive plans typically focus executives' attention on two to

four key measures over a 12-month period. Each measure should be tied to specific business objectives. Objectives should be established so that eligible executives can, by virtue of their day-to-day responsibilities, easily impact these objectives, and their roles should be positioned so that the impact has considerable magnitude. Long-term incentive plan measures are typically different from those in the short-term plan to align the goals and interests of executives with those enterprise performance characteristics highly valued by the organization's primary constituencies (e.g. shareholders, investors, the community, customers, etc.). Short-term business objectives such as member satisfaction and physician satisfaction should impact long-term goals such as enrollment. Sustained year-over-year growth in company net income should impact the long-term enterprise value of Horizon.

It is recommended that Horizon consider reviewing the compensation programs of its peer group companies (and large not-for-profit companies) to gain insight into the types of short- and long-term performance measures employed by those organizations. For-profit, publicly traded companies operate under a different set of corporate controls and objectives than non-profits such as Horizon. Therefore, it is also recommended that the Company establish a non-profit peer group to assess compensation levels as well as program design characteristics and prevailing practices. To the extent that Horizon considers other large non-profit organizations as part of its executive labor pool, its executive compensation program should in some way reflect the practices of those organizations.

It is recommended that Horizon re-evaluate its threshold, target, and optimum performance level-setting process pertinent to desired "likelihood of achievement". Long-term incentive payouts at greater-than-target levels have occurred 92% of the time, compared with 64% of the time for short-term incentive payouts. Horizon should examine whether the relative frequency of greater-than-target awards between long-term and short-term performance accurately describes the extent to which the Company is succeeding in its short- and long-range business goals. As short-term performance should ultimately drive long-term organizational value, the programs may be calibrated so that the frequency of annual incentive payouts influence the frequency of long-term awards.

SIGNATURES

In addition to the undersigned, the following examiners representing the State of New Jersey Department of Banking and Insurance participated in certain phases of this examination:

M. Patrick Tracy, CFE, CPA, RSM McGladrey, Inc.
Tom Ziemba, PhD, RSM McGladrey, Inc.
Steven T. Sullivan, RSM McGladrey, Inc.
Stanley Kaplan, CFE, CPA, RSM McGladrey, Inc.

I, Craig A. Moore, do solemnly swear that the foregoing Report on Examination is hereby represented to be a full and true statement on the limited scope of the Horizon Compensation Program Review as of March 29, 2008 to the best of my information, knowledge and belief.

Respectfully submitted,

_____/S/_____
Craig A. Moore, CFE
Examiner-in Charge
Representing the State of New Jersey
Department of Banking and Insurance

Under the Supervision of

_____/S/_____
Robert Kasinow, CFE
Chief Examiner
State of New Jersey
Department of Banking and Insurance

State of New Jersey
County of Mercer

Subscribed and sworn to before me, Donna M. Costigan, on this 21st day of August, 2008.

_____/S/_____
Donna M. Costigan
Notary Public of New Jersey

My commission expires: March 7, 2012

Appendix A – List of Public Peer Companies

Company	Revenue (\$Billions)	Industry	City	State
UnitedHealth Group Inc.	75.43	Health care plans	Minnetonka	MN
WellPoint Inc.	61.13	Health care plans	Indianapolis	IN
Aetna	27.6	Health care plans	Hartford	CT
Humana Inc.	25.29	Health care plans	Louisville	KY
Cigna Corporation	17.62	Health care plans	Philadelphia	PA
Health Net, Inc.	14.11	Health care plans	Woodland Hills	CA
Coventry Healthcare, Inc.	9.88	Health care plans	Bethesda	MD
Assurant, Inc.	8.45	Accident & Health Insurance	New York	NY
Community Health Systems Inc.	5.97	Hospitals	Franklin	TN
WellCare Health Plans, Inc.	4.76	Health care plans	Tampa	FL
Universal Health Services, Inc.	4.62	Hospitals	King Of Prussia	PA
Amerigroup Corp.	3.95	Health care plans	Virginia Beach	VA
Centene Corp.	2.86	Health care plans	St. Louis	MO
Molina Healthcare Inc.	2.49	Health care plans	Long Beach	CA
Pacificare Health Systems, Inc.	2.15	Health care plans	Cypress	CA
Magellan Health Services Inc.	1.96	Health care plans	Avon	CT
Sierra Health Services, Inc.	1.87	Health care plans	Las Vegas	NV
Healthextras, Inc.	1.72	Insurance Brokers	Rockville	MD
Apria Healthcare Group, Inc.	1.63	Home Health Care	Lake Forest	CA
Healthspring, Inc.	1.57	Health care plans	Nashville	TN
Universal American Financial Corp.	1.31	Holding Co.- Insurance	Rye Brook	NY
Healthways, Inc.	0.68	Specialized Health Services	Nashville	TN
America Service Group Inc.	0.6	Specialized Health Services	Brentwood	TN
Matria Healthcare, Inc.	0.35	Home Health Care	Marietta	GA

Appendix B – Sample Not-for-profit Companies

Company	Revenue (\$Billions)
Health Care Service Corporation	\$12.97
Ascension Health	\$12.32
Highmark, Inc.	\$11.08
Blue Cross Blue Shield of Michigan	\$8.69
Blue Shield of California	\$8.15
Mayo Clinic	\$6.12
Trinity Health	\$6.05
Salvation Army	\$5.30
YMCA's in the United States	\$5.10
<i>Average Revenue:</i>	<i>\$8.42</i>
<i>Median Revenue:</i>	<i>\$8.15</i>
<i>Horizon Healthcare Revenue:</i>	<i>\$8.10</i>